

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200827034**

Release Date: 7/4/2008

CC:ITA:B07:
POSTF-142598-07

UILC: 263A.08-00, 263A.08-01, 263A.10-00

date: March 13, 2008

to: Senior Counsel
(LMSB, Retailers, Food, Pharmaceuticals & Healthcare, Associate Area Counsel -
Chicago (Group 2), CC:LM:RFPH:CHI:2)

from: Branch Chief, Branch 7
(Income Tax & Accounting)

subject: POSTF-142598-07; Definition of Unit of Property for Interest Capitalization

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=	
z	=	
U	=	
V	=	
W	=	
t	=	
x	=	
y	=	
r	=	
s	=	
Date a	=	
Date b	=	
Date c	=	
Date d	=	

Date e	=	
Date f	=	
Location P	=	
Location S	=	
\$h	=	
\$i	=	
\$j	=	
\$k	=	
\$l	=	
\$m	=	
\$o	=	

ISSUE

Whether certain components of real and tangible personal property are functionally interdependent for purposes of § 1.263A-10(c) of the Income Tax Regulations?

FACTS

Taxpayer operates several processing and manufacturing facilities across the United States and worldwide. Taxpayer is principally engaged in z. Taxpayer's operations are classified into three reportable business segments: U, V, and W. Each segment is organized based upon the nature of products and services offered. Taxpayer's remaining operations are aggregated and classified as "Other" in its financial statements. Taxpayer also maintains a complex of t linking together the company and its customers and suppliers. Taxpayer uses an overall accrual method of accounting for federal income tax purposes.

Taxpayer historically and currently uses Authorization for Expenditures (AFE) as a management tool. AFEs are used to receive and document approval of expenditures above certain cost levels and outside of specific day-to-day activities and are categorized by type of expenditure (i.e., Expense AFE or Capital AFE). Typically, Capital AFEs provide information as to why the expenditures should be made, the purpose of the asset to be produced, and a breakdown of the types of expenditures (but not necessarily the components of the overall asset to be produced).

Taxpayer filed a Form 3115, Application for Change in Accounting Method, requesting permission to change its method of accounting for interest capitalization under § 263A(f) of the Internal Revenue Code and the Income Tax Regulations under that section for the taxable year beginning Date a. Under its present method, Taxpayer had determined the amount of capitalized interest on a per-project basis. Taxpayer claimed that this

method resulted in the inclusion of items of property that are not designated property in the accumulated production expenditures of the project.

Taxpayer signed a Consent Agreement issued by the Internal Revenue Service granting Taxpayer permission to change its method of accounting for interest capitalization for the taxable year beginning Date a. The Consent Agreement provided that Taxpayer will capitalize interest costs with respect to all property described in §§ 263A(f)(1) and 1.263A-8(b) (designated property), and will perform the avoided cost calculation on the basis of units of property as defined in § 1.263A-10. In addition, Taxpayer will treat interest capitalized on a unit of designated property as a cost of the unit of designated property in accordance with § 1.263A-8(a)(2), and will recover such capitalized interest in accordance with § 1.263A-1(c)(4). Interest capitalized on a unit of designated property containing one or more items of depreciable property (such as tangible personal property and depreciable real property) will be ratably allocated among such items of depreciable property, and will be depreciated in accordance with the Code and regulations that are applicable to such property. Also, Taxpayer will cease capitalization of interest with respect to (i) property that are not units of designated property within the meaning of § 1.263A-8(b) and (ii) property meeting the de minimis rule in § 1.263A-8(b)(4).

Taxpayer has been involved in several capital expansion projects for which AFEs have been established. In its Form 3115, Taxpayer included 2,062 individual assets segregated from 167 individual AFEs. After issuance of the Consent Agreement, Taxpayer determined that it had overcapitalized interest on property that was not designated property, or had suspension periods in excess of 120 days, or on which interest was accrued after production was completed. Taxpayer reduced the basis of these assets in order to remove the interest it determined was erroneously capitalized.

This request highlights seven AFEs from which Taxpayer identified property that was not designated property. These seven projects included co-generation plant expansions, a co-generation plant addition, and a x plant expansion. The information reviewed does not indicate that any assets included in the co-generation or r plant AFEs were placed in service with, or used in support of, the existing co-generation or r plants, as applicable, prior to the completion of the expansion or addition projects.

AFE 9412261, authorized in Date b for \$h, was part of a steam and power generation expansion project at the Location P co-generation facility to accommodate increased processing plant expansion. AFE 9412261 contained 52 component assets of which 9 are real property components and the remaining 43 are tangible personal property components. Taxpayer and the Internal Revenue Service agree that the 9 real property components are functionally interdependent real property components considered one unit of real property. Among the components identified for this AFE were: one coal fired boiler, two gas fired boilers, a bagger, cyclones, ductwork, fans, gas lines, heaters, computer controls and instrumentation, piping, pumps, smoke stack additions, valves, meters, catwalks, grating, filters, steam lines, turbines, and other related components.

AFE 9412264, authorized in Date b for \$i, also was part of the steam and power generation expansion project at the Location P co-generation facility, but was limited to the construction of a coal conveyor system for use at the facility. AFE 9412264 contained 5 component assets of which 2 are real property components and the remaining 3 are tangible personal property components. Among the components identified for this AFE were: building additions, conveyors, computers, insulation, and special purpose structures.

The project descriptions for AFE's 9412261 and 9412264 each provide: "With increased grind rate of _____ BPD and expansion of Bio-Products plus additional Bio-product processes being built, steam and power generation expansion are needed.

Coal Boiler, _____ turbine generator and _____ gas boilers will be installed. This will allow for down time for yearly maintenance on _____ existing coal boilers and _____ turbine generators without reductions in production. It will also make _____ existing gas boilers available for other plants and provide needed space for future expansion." The Location P co-generation facility expansion was designed to produce up to an additional _____ megawatts of electrical power and _____ pounds of steam per hour.

AFE 9603172, authorized in Date c for \$j, involved the installation of new feedwater heaters at the expanded Location P co-generation facility. AFE 9603172 contained 7 component assets of which 1 is a real property component and the remaining 6 are tangible personal property components. Taxpayer and the Internal Revenue Service agree on the amount of capitalized interest for the real property component. Among the components identified for this AFE were: a boiler, water heater, piping, insulation, and other instrumentation.

The project description for AFE 9603172 provides: "Due to the number of tube failures and marginal size, new feedwater heaters are required for Co-generation. The existing units can be refurbished to be used in the [Location S] Co-generation facility, which will require larger heaters to accommodate the expansion at that location."

AFE 9601784, authorized in Date d for \$k, was part of a steam and power generation expansion project at the Location S co-generation facility. AFE 9601784 contained 159 component assets of which 12 are real property components and the remaining 147 are tangible personal property components. Taxpayer and the Internal Revenue Service agree that the 12 real property components are functionally interdependent real property components considered one unit of real property. Among the components identified for this AFE were: a coal fired boiler, bag filter system, control system, ductwork, smoke stack, electrical equipment, building modifications, equipment foundations, hoppers, piping, silencer, platforms, steam separators, strainers, storage bins, equipment supports, transformers, air compressor, coal and limestone conveying equipment, blowers, catwalks, computer process control systems, cyclones, dust collector, freight elevator, elevator man-lift, filling equipment, fans, grating,

instrumentation, equipment supports, electrical turbine generator, water treatment equipment, pipes, valves, and other related components.

The project description for AFE 9601784 provides: “Construct circulating fluid bed boiler at [Location S]. Capacity pounds steam per hour.”

AFE 9705172, authorized in Date e for \$l, also was part of the steam and power generation expansion project at the Location S co-generation facility, but was limited to the installation of boilers and turbine generators. AFE 9705172 contained 61 component assets of which 10 are real property components and the remaining 51 are tangible personal property components. Taxpayer and the Internal Revenue Service agree that the 8 of the 10 real property components are functionally interdependent real property components considered one unit of real property and that the remaining 2 are functionally independent. Among the components identified for this AFE were: a turbine, condenser, cooling tower, bagger, catwalk, dryer, electrical equipment, computer processing equipment, pumps, tanks, building structural changes, man-lift elevator, transformer, equipment foundations, grating, gear reducer, motor control center, valves, spill containment, weigh feeder, and other related components.

The project description for AFE 9705172 provides: “It is proposed to install a -MW Automatic Dual Extraction, Condensing Steam Turbine Generator at the [Location S] Co-Generation Plant. The machine maximizes our steam and electrical loading flexibility while producing cents / KW Power.”

AFE 9800223, authorized in Date f for \$m, also was part of the steam and power generation expansion project at the Location S co-generation facility, but was limited to the installation of an ion exchange addition. AFE 9800223 contained 34 component assets of which 4 are real property components and the remaining 30 are tangible personal property components. Taxpayer and the Internal Revenue Service agree that the 4 real property components are functionally interdependent real property components considered one unit of real property. Among the components identified for this AFE were: a crane for ion exchange addition, deionization system, duct work, electrical equipment, filters, ion exchange feed system, resin-ion exchanger addition, valves, building additions, catwalk, control systems, piping, instrumentation, and other related components.

The project description for AFE 9800223 provides: “In order to maintain plant reliability, additional water treatment capacity is needed at the Co-Generation Plant. It is proposed to add an ion-exchange carousel capable of providing -GPM or continuous make-up water.”

AFE 9603086, authorized in Date c for \$o, was for the expansion of x processing at the Location P facility. AFE 9603086 contained 64 component assets of which 6 are real property components and the remaining 58 are tangible personal property components. Taxpayer and the Internal Revenue Service agree that the 6 real property components

are functionally interdependent real property components considered one unit of real property. Among the components identified for this AFE were: an air compressor, conveyor, bag filter, blower, condenser, cooling tower, dryer, duct work, dust collector, electrical, ejector, extractor, fan, filters, fiber grinder, heat exchanger, instrumentation, insulation, motors, piping, pumps, platform, cracking roll, scale, screw press, transformer, valves, tanks, catwalk, and other related components.

The project description for AFE 9603086 provides: "To [x] capacity to mm lb per year will require [the components listed above]." The Service's examination team's meetings with Taxpayer indicated that this new facility was constructed to produce three new s products. The raw material for these new products is y, a product already produced at the facility prior to the expansion. The facility's expansion would put the y through a removal process followed by a drying process for ultimate use in the three new s products. The three new products required the y be put through the removal and drying processes.

Based upon advice received from Taxpayer's representatives, in implementing the change in accounting method authorized by the Consent Agreement, Taxpayer treated each tangible personal property component within each AFE as a discreet asset representing a separate unit of property for purposes of § 263A(f) of the Internal Revenue Code.

LAW AND ANALYSIS

Section 263A(a) provides that in the case of any property to which § 263A applies, any costs described in § 263A(a)(2) shall be included in inventory costs (in the case of property which is inventory in the hands of the taxpayer), or shall be capitalized (in the case of property that is not inventory in the hands of the taxpayer).

Section 263A(a)(2) provides that the costs described by such paragraph with respect to any property are (i) the direct costs of such property; and (ii) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.

Section 263A(b)(1) provides that, except as otherwise provided, § 263A applies to real or tangible personal property produced by the taxpayer.

Section 263A(f)(1) provides that § 263A(a) shall apply only to interest costs which (i) are paid or incurred during the production period, and (ii) are allocable to property which is described in § 263A(b)(1) and which has a long useful life, an estimated production period exceeding 2 years, or an estimated production period exceeding 1 year and a cost exceeding \$1,000,000.

Section 263A(f)(4)(A) provides that, for purposes of § 263A(f), property has a “long useful life” if such property is real property, or property with a class life of 20 years or more (as determined under § 168).

Section 263A(f)(4)(B) provides that, for purposes of § 263A(f), the term “production period” means, when used with respect to any property, the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or is ready to be held for sale.

Section 1.263A-8(a)(1) provides that capitalization of interest under the avoided cost method described in § 1.263A-9 is required with respect to the production of designated property described in § 1.263A-8(b).

Section 1.263A-8(b)(1) provides that, except as provided in §§ 1.263A-8(b)(3) and 1.263A-8(b)(4), “designated property” means any property that is produced and that either is (i) real property; or (ii) tangible personal property (as defined by § 1.263A-2(a)(2)) which is (A) property with a class life of 20 years or more under § 168 (long-lived property), but only if the property is not property described in § 1221(1) in the hands of the taxpayer or a related person; (B) property with an estimated production period (as defined in § 1.263A-12) exceeding 2 years (2-year property); or (C) property with an estimated production period exceeding 1 year and an estimated cost of production exceeding \$1,000,000 (1-year property).

Section 1.263A-8(b)(2) provides that the thresholds described in § 1.263A-8(b)(1) are applied separately for each unit of property as defined in § 1.263A-10.

Section 1.263A-8(d)(1) provides that “produce” is defined as provided in §§ 263A(g) and 1.263A-2(a)(1)(i). Section 263A(g)(1) provides that, for purposes of § 263A, the term “produce” includes construct, build, install, manufacture, develop or improve. Section 1.263A-2(a)(1)(i) provides that, for purposes of § 263A, “produce” includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

Section 1.263A-8(c)(1) provides that “real property” includes land, unsevered natural products of land, buildings, and inherently permanent structures.

Section 1.263A-8(c)(3) provides that “inherently permanent structures” include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former § 48(a)(1)(B) and § 1.48-1. Any property not otherwise

described in § 1.263A-8(c)(3) that constitutes other tangible property under the principles of former § 48(a)(1)(B) and § 1.48-1(d) is treated for the purposes of § 1.263A-8 as an inherently permanent structure.

Section 1.263A-12(c)(1) provides that a separate production period is determined for each unit of property defined in § 1.263A-10. Section 1.263A-10(a) provides that whether property is 1-year or 2-year property under § 1.263A-8(b)(1)(ii) is also determined separately with respect to each unit of property as defined in § 1.263A-10.

Section 1.263A-10(b)(1) provides that a unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property even though the common feature does not meet the functional interdependence test. When the production period begins with respect to any functionally interdependent component or any common feature of the unit of real property, the production period has begun for the entire unit of real property.

Section 1.263A-12(c)(2) provides that the production period of a unit of real property begins on the first date that any physical production activity (as defined in § 1.263A-12(e)) is performed with respect to a unit of real property. Section 1.263A-12(e)(1) provides that the term “physical production activities” includes any physical activity that constitutes production within the meaning of § 1.263A-8(d)(1).

Section 1.263A-12(c)(3) provides that the production period of a unit of tangible personal property begins on the first date by which the taxpayer’s accumulated production expenditures, including planning and design expenditures, are at least 5 percent of the taxpayer’s total estimated accumulated production expenditures for the property unit. Thus, the beginning of the production period is determined without regard to whether physical production activity has commenced. The production period for a unit of tangible personal property produced under a contract begins for the customer when the customer’s accumulated production expenditures are at least 5 percent of the customer’s total estimated accumulated production expenditures.

Section 1.263A-12(d)(1) provides that the production period for a unit of property produced for self use ends on the date that the unit is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed.

Section 1.263A-10(b)(2) provides that components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.

Section 1.263A-10(c) provides that components of tangible personal property are a single unit of property if the components are functionally interdependent. Components

of tangible personal property that are produced by, or for, the taxpayer, for use by the taxpayer or a related person, are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.

Section 1.263A-8(a)(4)(ii) provides that, for purposes of §§ 1.263A-8 through 1.263A-15, placed in service has the same meaning as set forth in § 1.46-3(d) (providing rules relating to the qualification of property investments for the investment tax credit).

Section 1.46-3(d)(1) provides that property shall be considered placed in service in the earlier of (i) the taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or (ii) the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function.¹ Section 1.46-3(d)(2) provides that, in the case of property acquired by the taxpayer for use in his trade or business (or in the production of income), the following are examples of cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function: (i) parts are acquired and set aside during the taxable year for use as replacements for a particular machine (or machines) in order to avoid operational time loss, (ii) operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year, and (iii) equipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects. However, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for a specifically assigned function.

Although courts have not addressed the issue in the context of § 263A(f), several cases have dealt with the definition of "placed in service" for purposes of § 1.46-3(d). With respect to electrical power generation facilities, courts have applied the test announced in several revenue rulings that an electrical generating plant is placed in service when the necessary permits and licenses have been obtained, all critical tests necessary for proper operation have been performed, the unit has been placed in the control of the taxpayer by the construction contractor, the unit has been synchronized with the transmission grid, and daily operation of the unit has begun. See Rev. Rul. 76-428, 1976-2 C.B. 47; Rev. Rul. 76-256, 1976-2 C.B. 46; Oglethorpe Power Corp. v. Commissioner, T.C. Memo. 1990-505; Sealy Power, Ltd. V. Commissioner, 46 F.3d 382 (5th Cir. 1995), *nonacq.* 1995-2 C.B. 1.

Several cases have examined whether component assets may be regarded as individual units of property for purposes of depreciation and the investment tax credit. In Public Service Co. of N.M. v. United States, 431 F.2d 980 (10th Cir. 1970), the Tenth

¹ Because of the depreciation conventions under § 168, the taxable years in (i) and (ii) are the same for property subject to depreciation under § 168.

Circuit considered whether the component assets of an electrical power plant could be placed in service before the entire plant was placed in service. The component assets were a turbine-generator, a steam generating unit, a cooling tower, a transformer, and a main power plant building. The court held that the various assets were placed in service when the entire plant became operational, stating that:

No one of these [component assets] . . . would serve any useful purpose to [Public Service Co.] but all of them properly fitted together by the contractor, together with the building, constituted a completed unit which was operational and served the purpose intended by [Public Service Co.]. It was this complete operational unit that [the contractor] agreed to construct from the many components and deliver to [Public Service Co.] as an electrical power generating plant.

Id. at 984.

Similarly, in Hawaiian Independent Refinery, Inc. v. United States, 697 F.2d 1063 (Fed. Cir. 1983), the court considered the issue of defining the applicable unit of property for purposes of applying the construction exception to the restoration of the investment tax credit in 1971. The taxpayer argued that a refinery, marine terminal, and product pipelines were separate properties for purposes of applying the transition rule. However, the trial court reasoned that the marine terminals transport raw materials to the refinery, and the pipelines connect the refinery to storage facilities, so the two offsite components, together with the refinery itself, “functionally form a single property.” Id. at 1069. In affirming the decision, the court of appeals concluded that the trial court’s approach was reasonable “particularly since the refinery complex was conceived, designed, and constructed as a unit, the three components being placed in operation concurrently.” Id.

In Consumers Power Co. v. Commissioner, 89 T.C. 710 (1987), the Tax Court examined the issue of whether an upper reservoir and a hydroelectric plant facility should be considered a single unit of property for purposes of depreciation and the investment tax credit. For the electrical power generation facility to operate as intended, water would flow down from the upper reservoir to a lower reservoir through tunnels, turning hydraulic turbine generators on its way down, and thereby producing electric power. Construction of the upper reservoir was completed in 1972 but the power facility was not operational until 1973 and the taxpayer argued that the upper reservoir should be treated as placed in service when it was available for use in 1972. The court concluded that both components “must be viewed as one integrated unit because the physical plant and the reservoir operate simultaneously and as a unit in order to produce electrical power.” Id. at 726.

The Tax Court addressed a similar issue in Armstrong World Industries, Inc. v. Commissioner, T.C. Memo. 1991-326, *aff’d*, 974 F.2d 422 (3rd Cir. 1992). In Armstrong World Industries, the issue was the unit of property qualifying for investment tax credits

and depreciation deductions under the now repealed safe-harbor leasing rules. In order to qualify for accelerated deduction under the safe-harbor leasing rules, property must have been placed in service during a specified transition period. The definition of “placed in service” for purposes of the safe-harbor leasing rules was identical to the definition provided in § 1.46-3(d). The taxpayer entered into leasing agreements to acquire various railroad properties, and argued that all properties acquired were interdependent component parts comprising a single unit of property that could not be considered placed in service until the final rail track project was completed. The Third Circuit, affirming the Tax Court, held that the various track segment projects had independent utility prior to the time all of the project components were completed. After reviewing Public Service Co., Hawaiian Independent Refinery, and Consumers Power, the court stated:

In sum, courts appear to agree that individual components will be considered a single property for tax purposes when the component parts are functionally interdependent – when each component is essential to the operation of the project as a whole and cannot be used separately to any effect. The converse, thus, should be equally valid in this case. Accordingly, if a project has component parts which can function as planned in a wholly *independent* manner, then a court may find that each component is a “property . . . placed in a condition or state of readiness and availability for a specifically assigned function.

Id. at 434. [emphasis in original] [internal citation omitted]

The Third Circuit’s approach in determining whether individual components should be considered a single unit of property by examining the functional independence or interdependence of the various component assets is consistent with the approach of § 1.263A-10 as expressed in the preamble to the final interest capitalization regulations. See T.D. 8584, 1995-1 C.B. 20. Commentators recommended that the final regulations define a unit of property to include “each operating unit that performs a discrete function” by referencing the definition provided in § 1.167(a)-11(d)(2)(vi). In addressing this recommendation, the preamble to the final regulations states:

The §1.167(a)-11(d)(2)(vi) definition of a unit may not encompass the functionally interdependent components of property. This definition of a unit applied for purposes of applying the alternative depreciation (ADR) repair allowance provisions, which were elective. The provisions provided a simplification procedure for treating a taxpayer’s expenditures as either capitalized expenditures or deductible expenses. Taxpayers that elected the provisions, and used this §1.167(a)-11(d)(2)(vi) definition of a unit, we[re] required to use the same standard that other taxpayers used in determining the date on which property was placed in service (i.e., the standard consistent with the concept of a single property as an aggregation of functionally interdependent components). Accordingly, the final regulations do not adopt commentators’ recommendation to modify the definition of a unit of property.

We will apply the rules set forth above to the projects identified in your submission. As part of our analysis we will also examine some of the arguments offered by the taxpayer.

a. Steam and power generation expansion projects at Location P co-generation facility (AFE 9412261 and AFE 9412264)

Based on the facts presented, the purpose of the steam and power generation expansion projects at the Location P co-generation facility was to increase the amount of steam and electrical power generated at the facility in order to accommodate increased processing operations at that location. With respect to AFE 9412261, relating to the installation of a new boiler at the facility, each of the tangible personal property components identified in the AFE are essential to the operation of the boiler in its role in accomplishing the project's intended function of increasing power generation at the facility. Moreover, each of the assets identified in the AFE are essential to the intended purpose of the Location P steam and power generation expansion project. There is no indication that any one of the tangible personal property components has any utility to Taxpayer apart from their combined role in fulfilling the purpose of the expansion project. The facts further indicate that the tangible personal property components identified in AFE 9412261 were not used in combination with any existing assets prior to completion of the expansion project.

Similarly, with respect to AFE 9412264, relating to the installation of a new coal conveyor system at the facility, each of the tangible personal property components identified in the AFE are essential to the operation of the coal conveyor system in its role in accomplishing the project's intended function of increasing power generation at the facility. Moreover, just as the marine terminal, pipelines, and refinery were found functionally interdependent in Hawaiian Independent Refinery, the tangible personal property components of the coal conveyor system appear functionally interdependent with the other tangible personal property components installed as a part of the entire Location P steam and power generation expansion project. Absent any use of the coal conveyor system in combination with existing assets, there is no indication that the conveyor would have any utility to Taxpayer apart from its role in fulfilling the purpose of the expansion project.

Taxpayer has offered several arguments in support of its position that a discreet asset that can function independently of another discreet asset should be considered "functionally independent" of such other asset, regardless of whether or not the asset is essential to the operation of the project as a whole. First, Taxpayer suggests an equivalency between the unit of property for purposes of § 263A(f) and the unit of property for purposes of §§ 162 and 263(a). For example, Taxpayer cites FedEx Corp. v. United States, 291 F.Supp.2d 699 (W.D.Tenn. 2003), *aff'd*, 412 F.3d 617 (6th Cir. 2005). In FedEx, the taxpayer incurred periodic costs in servicing the engines used in its aircraft fleet and sought to deduct the expenses as incidental repairs. To decide

whether the expenses were currently deductible, the court had to determine whether the applicable unit of property was the aircraft or the engine. Despite the taxpayer's urging, the court expressly declined to adopt the functional interdependence test of § 1.263A-10 as an absolute test to determine the unit of property for purposes of §§ 162 and 263(a). FedEx, 291 F.Supp.2d at 712, n.10. Rather, the court concluded that functional interdependence was only one factor among several factors that must be considered in resolving the unit of property issue for purposes of §§ 162 and 263(a). Since functional interdependence is only one factor among several factors that are relevant under §§ 162 and 263(a), the unit of property that is determined under those sections is not necessarily the unit of property for purposes of § 263A(f).

Taxpayer also relies upon Northern States Power Co. v. United States, 151 F.3d 876 (8th Cir. 1998), *aff'g in part, rev'g in part*, 952 F.Supp. 1346 (D.Minn. 1997). In Northern States Power, the taxpayer argued that fuel assemblies, a component of a nuclear power reactor, which were acquired to replace existing fuel assemblies were placed in service when received and not when they were later installed in the nuclear reactor. The taxpayer's express purpose in acquiring the fuel assemblies was to maintain power output at the facility, not to increase power production. The court held that the replacement fuel assemblies were a distinct unit of property from the entire nuclear power facility, thus the taxpayer was allowed investment tax credit and depreciation deductions for the assemblies in the taxable year in which they were received.

Because Taxpayer's projects are part of an expansion of or addition to existing facilities, Taxpayer also relies upon Piggly Wiggly Southern, Inc. v. Commissioner, 84 T.C. 739 (1985), *aff'd*, 803 F.2d 1572 (11th Cir. 1986). In Piggly Wiggly, the taxpayer claimed depreciation deductions and investment tax credit in the taxable year in which it purchased new equipment for use in the operation of new, relocated, and remodeled stores. The equipment for the remodeled stores was installed, operating, and in use in these stores in the year of purchase. The equipment for the new and relocated stores was placed in stores that were not open for business in the year of purchase. The court held that the equipment for the remodeled stores was placed in service in the year of purchase but the equipment for the new and relocated stores was not placed in service in the year of purchase.

In our view, Taxpayer's reliance on these cases is misplaced. As the Sixth Circuit explicitly recognized in FedEx, functional interdependence for purposes of interest capitalization is distinct from the unit of property test applied for purposes of §§ 162 and 263(a). Functional interdependence is only one factor among several that is relevant under §§ 162 and 263(a), such that the unit of property determined under §§ 162 and 263(a) is not necessarily the unit of property for purposes of § 263A(f). In addition, the fuel assemblies in Northern States Power were conceded to have been acquired fully assembled and ready to be placed within the reactor. The only issue was whether the taxpayer actually had to use the replacement assemblies for the parts to be considered "placed in service." In contrast, in the instant case, there is no assertion that the expansion undertaken by Taxpayer, as represented in AFE 9412261 and AFE 9412264,

was intended to replace any part of the existing power generation facility. Rather, the project's intended purpose was expansion of capacity at the existing power generation facility. Further, unlike the equipment in the remodeled stores in Piggly Wiggly, the expansion of the co-generation facility more closely resembles a new facility and the components that are purchased or constructed for the expansion of the co-generation facility cannot operate and be in use for the intended purpose of the project until all of the components of the expansion are complete.

Therefore, based on the foregoing analysis and the facts presented, we conclude that all tangible personal property components essential to the operation of the Location P steam and power generation expansion project as a whole, for example, as those identified in AFE 9412261 and AFE 9412264, are functionally interdependent for purposes of §263A(f). Similarly, we further conclude that all real property components essential to the operation of the Location P steam and power generation expansion project as a whole, for example, as those identified in AFE 9412261 and AFE 9412264, are functionally interdependent for purposes of §263A(f). We note, however, a unit of property that is comprised of real property components is a distinct unit of property for purposes of § 263A(f) from the unit of property that is comprised of tangible personal property components.

b. Feedwater heater upgrade at the Location P facility (AFE 9603172)

Based on the facts presented, the purpose of the feedwater heater upgrade project, represented by AFE 9603172, was to replace the existing heaters because of failure of the existing units and because the old units were too small to handle the capacity required for the expanded co-generation facility. Each of the tangible personal property components identified in the AFE are essential to the operation of the feedwater heaters in their role in accomplishing the intended function of the project. There is no indication that any one of the tangible personal property components has any utility to Taxpayer apart from their combined role in fulfilling the purpose of the project. The facts further indicate that the tangible personal property components identified in AFE 9603172 were not used in combination with any existing assets prior to completion of the project.

Therefore, based on the foregoing analysis and the facts presented, we conclude that all tangible personal property components identified in AFE 9603172 are functionally interdependent for purposes of §263A(f). However, the unit of property identified in AFE 9603172 may be used to replace existing feedwater heaters at the facility and, thus, is not functionally interdependent with the properties used in the entire Location P steam and power generation expansion project (for example, as those identified in AFE 9412261 and AFE 9412264).

c. Steam and power generation expansion project at the Location S co-generation facility (AFE 9601784, AFE 9705172, and AFE 9800223)

Based on the facts presented, the purpose of the steam and power generation expansion project at the Location S co-generation facility is identical to that identified for the Location P steam and power generation expansion project. Each of AFE 9601784, AFE 9705172, and AFE 9800223 relate to the Location S steam and power generation expansion project and each of the tangible personal property components identified in these AFE's are essential to Taxpayer accomplishing the intended function of the expansion project to increase power generation at the facility. There is no indication that any one of the tangible personal property components has any utility to Taxpayer apart from their combined role in fulfilling the purpose of the expansion project. The facts further indicate that the tangible personal property components identified in AFE 9601784, AFE 9705172, and AFE 9800223 were not used in combination with any existing assets prior to completion of the expansion project.

Therefore, based on the foregoing analysis and the facts presented, we conclude that all tangible personal property components essential to the operation of the Location S steam and power generation expansion project as a whole, for example, as those identified in AFE 9601784, AFE 9705172, and AFE 9800223, are functionally interdependent for purposes of §263A(f).

d. Expansion of x processing capacity at Location P facility (AFE 9603086)

Based on the facts presented, the purpose of the x expansion project, represented by AFE 9603086, was to expand the existing x processing facility to enable the removal and drying processes and ultimately produce three new s products. Each of the tangible personal property components identified in the AFE are essential to the expanded operation of the facility in their role in accomplishing the intended function of the project. There is no indication that any one of the tangible personal property components has any utility to Taxpayer apart from their combined role in fulfilling the purpose of the project. The facts further indicate that the tangible personal property components identified in AFE 9603172 were not used in combination with any existing assets prior to completion of the project.

Taxpayer argues that the functionality of the drying process, which follows the removal process, is not dependent upon the removal process. Furthermore, its preexisting grinding process, which follows the drying process, is not dependent upon the removal or drying processes. In fact, Taxpayer represents that it could purchase r that had been through the removal process and then start its own production with the drying process. However, the fact that each of these processes – removal, drying, and grinding – could be pursued separately does not change Taxpayer's intended purpose in undertaking the expansion project. Taxpayer sought to produce three new s products, and such production was dependent on the facility's expansion to provide for the removal and drying processes. There is no factual evidence to indicate Taxpayer used, or intended to use, the expanded facility for any purpose other than the production of the three new s products.

Therefore, based on the foregoing analysis and the facts presented, we conclude that all tangible personal property components identified in AFE 9603172 are functionally interdependent for purposes of §263A(f).

No opinion is expressed or implied regarding whether any individual component asset is properly characterized as a real property component or a tangible personal property component within the meaning of § 1.263A-10.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions.

Associate Chief Counsel
(Income Tax & Accounting)

By: Kathleen Reed

Kathleen Reed
Branch Chief, Branch 7
(Income Tax & Accounting)